DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 00-0373
Indiana Corporate Income Tax
For the Tax Years 1996, 1997, and 1998

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ISSUES

I. Telephone Cooperative's Addback of Taxes Attributable to Patronage Income – Adjusted Gross Income.

Authority: 45 IAC 3.1-1-8; 45 IAC 3.1-1-8(3)(a), (b); I.R.C. § 164; I.R.C. § 277.

Taxpayer argues that income and property taxes, attributable to income received from its own patrons, should not be added back in calculating its Indiana adjusted gross income.

II. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c); 45 IAC 15-11-2(c)(1), (4).

Taxpayer maintains that – based upon the particular nature of taxpayer's business and the tax questions unique to that business – it is entitled to an abatement of the ten-percent negligence penalty assessed at the time of the original audit.

STATEMENT OF FACTS

Taxpayer is a telephone cooperative in the business of providing telephone service to several Indiana communities. Taxpayer receives income from "patrons" and from "non-patrons." Until 1993, taxpayer was classified as a tax-exempt entity under I.R.C. § 501(c)(12). However, beginning in 1994, taxpayer no longer qualified as a tax-exempt entity because it no longer received 85 percent of its income from patrons. Thereafter, taxpayer filed as a "non-exempt cooperative" differentiating between income received from patrons and income received from non-patrons.

The Department of Revenue (Department) conducted an audit of taxpayer's 1996, 1997, and 1998 financial records and tax returns. In calculating the taxpayer's adjusted gross income tax, the audit added back income and property taxes attributable to obtaining its patronage income. As a result, the Department determined that taxpayer owed additional state income tax. The taxpayer disagreed with the audit's methodology arguing that only those income and property taxes associated with non-patronage income should be added back; the income and property taxes associated with the patronage income should not have been added back. Taxpayer submitted a protest challenging the audit's methods and the consequent additional tax assessments. An administrative hearing was held, and this Letter of Findings results.

DISCUSSION

I. <u>Telephone Cooperative's Addback of Taxes Attributable to Patronage Income</u> – Adjusted Gross Income.

Taxpayer failed to qualify as a tax exempt organization under I.R.C. § 501 because it no longer received 85 percent of its income from its patron members. Thereafter – pursuant to I.R.C. § 277 – in reporting its income for federal income tax purposes, taxpayer differentiated between income and expenses attributable to its patrons and the income and expenses attributable to its non-patrons. The bottom-line effect of this distinction is that taxpayer paid federal income tax on that portion of its income received from its non-patrons and did not pay taxes on income received from its patrons.

In a substantially simplified manner – and as far as relevant to the issue raised by the taxpayer – taxpayer calculates its federal adjusted gross income tax in the following manner.

In the first step – and for the purposes of this illustration – assume that taxpayer received $5,000 in gross receipt income from its patrons but also paid $1,000 in gross income and property taxes attributable to the acquisition of the $5,000. On its federal return, taxpayer would be entitled to deduct the $1,000 from the $5,000 yielding $4,000 in patronage "taxable income."

In the second step, assume also that taxpayer also received $2,500 in non-patronage income and paid $300 in gross income and property taxes attributable to acquisition of that particular non-patronage income. On its federal return, taxpayer would again be entitled to deduct the $300 yielding $2,200 in "taxable income" from its non-patronage members.

In the third step, taxpayer returns to the original gross receipts – the $5,000 and the $2,500 – to arrive at "total income" of $7,500. However, in arriving at its final "taxable income," taxpayer is entitled to deduct the $4,000 in patronage "taxable income" from the "total income." The consequence is that taxpayer has $3,500 in bottom line, federal taxable income. In summary, after deducting the associated property and gross income taxes, taxpayer does not pay federal adjusted gross income tax on the remaining patronage income – the $4,000 noted above.

As illustrated previously, the Department does not challenge the taxpayer's federal methods or calculations. The dispute arises when taxpayer adapts those same calculations in arriving at its Indiana adjusted gross income tax.

In calculating taxpayer's Indiana adjusted gross income, taxpayer begins with the federal adjusted gross income (the $3,500 cited in the example above) and then makes certain adjusted adjustments. Specifically, 45 IAC 3.1-1-8 states as follows:

“Adjusted Gross Income” with respect to corporate taxpayers is “taxable income” as defined in Internal Revenue Code section 63 with three adjustments.

> (1) Subtract income exempt from tax under the Constitution and Statutes of the United States.
>
> (2) Add back deductions taken pursuant to Internal Revenue Code section 170 (Charitable contributions);
>
> (3) Add back deductions taken pursuant to Internal Revenue Code section 63 for:
>
> > (a) Taxes based on or measured by income levied at the state level. . .
> >
> > (b) Property taxes levied by a political subdivision of any state; and
> >
> > (c) Indiana motor vehicle excise taxes, except for that portion of the tax not considered an ad valorem tax.

The dispute arises from the Indiana provision which requires the state taxpayer to add back “property taxes” and “taxes based on or measured by income.” 45 IAC 3.1-1-8(3)(a), (b).

Taxpayer argues that it is required to add back only those property and gross income taxes associated with the non-patronage income. In the example above, taxpayer maintains that it would begin with $3,500 and add back the $300. As a result, taxpayer would have $3,800 in Indiana adjusted gross income.

The audit maintained that taxpayer is required to add back those property and gross income taxes associated with the non-patronage income *and* the property and gross income taxes associated with the patronage income. In the example above and employing the audit’s proposed method, the taxpayer would start with the $3,500, add back the $300, and *also* add back the $1,000. As a result of the two additions, taxpayer would have $4,800 in Indiana adjusted gross income.

In support of its argument, taxpayer maintains that the starting point for determining the states adjusted gross income is non-patronage taxable income; in effect, the patronage sourced gross income tax and the property tax were never a component of the federal taxable income. According to taxpayer, “It simply is not logical to add back expenses that were never deducted in the first place. To do so creates phantom income.”

Taxpayer is not required to pay federal income tax on income received from its patrons. I.R.C. § 277 states, in relevant part, as follows:

> In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent

of income derived during such year *from members or transactions with members*." (*Emphasis added*).

As a "membership organization" which functions to provide its patrons with telephone services, taxpayer is clearly permitted to "deduct" the income received from those patrons. Equally clear is that 45 IAC 3.1-1-8 does not require taxpayer to add back the total patron income in determining its Indiana adjusted gross income.

In addition, taxpayer – along with every other taxpayer – is entitled to deduct state and local real or personal property taxes and state and local income taxes. I.R.C. § 164 states in part that:

> Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
>
> (1) State and local, and foreign, real property taxes.
>
> (2) State and local personal property taxes.
>
> (3) State and local, and foreign, income, war profits, and excess profits taxes . . .
>
> In addition, there shall be allowed as a deduction State and local, and foreign taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business . . . .

Therefore, under I.R.C. § 164, taxpayer is entitled to deduct those property and local income taxes which are paid in association with patronage and non-patronage income. There is nothing discernible which restricts or limits the taxpayer from deducting those particular expenses from both sources of taxpayer's income. This conclusion is reinforced by the particular federal form employed by taxpayer in distinguishing its forms of income. Form 8817, entitled "Allocation of Patronage and Nonpatronage Income and Deductions," provides in lines 12 through 29 specific provisions whereby taxpayer is permitted to specify and then deduct its local income and property taxes from both its "Patronage" (column a) and from its "Nonpatronage" (column b) "taxable income."

Under I.R.C. § 164, taxpayer was plainly entitled to "deduct" local gross income and property taxes from both its patronage and non-patronage income. The additional fact that, under I.R.C. § 277, taxpayer was also entitled to deduct the sum of its patronage income does not nullify the effect of the deduction permitted under I.R.C. § 164. The obligation placed on taxpayer under 45 IAC 3.1-1-8(3)(a), (b) requires that taxpayer add back the local gross income and property taxes deducted; there is simply no reasonable reading of the regulation which permits the taxpayer to add back *some* income and property taxes but ignore the parallel deduction it made of other income and property taxes. Taxpayer is correct that the federal tax is assessed against its non-patronage income. Nonetheless, in arriving at its federal adjusted gross income – however intricate that calculation may have been – it deducted gross income and property taxes from *both* its patronage and non-patronage income. Those taxes must be added back.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayers ask the Department to exercise its discretionary authority and abate the ten-percent negligence penalty assessed at the time the audit report was concluded.
IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if a tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) permits the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . ."

The factors which "may be considered in determining reasonable cause" include the "nature of the tax involved" and the "published department instructions, information bulletins, letters of findings, rulings, [and] letters of advice." 45 IAC 15-11-2(c)(1), (4).

Given the nature of taxpayer's business and the tax laws implicated by that particular business, it cannot be said that the taxpayer failed to exercise "ordinary business" care in arriving at the decisions it did. The Department finds that abatement of the ten-percent negligence penalty is warranted.

FINDING

Taxpayer's protest is sustained.

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